

Firm growth expected in Japan despite rising downside risks

Global oil shocks pose significant risks to Japan's economic growth and inflation. However, Sanaenomics can help alleviate certain risk factors



'Sanaenomics' is expected help alleviate certain risk factors for Japan's economy

Tax cut pledge will eventually be implemented, though details remain lacking

With the landslide victory of Japan's Liberal Democratic Party (LDP) in February, Prime Minister Sanae Takaichi's "responsible and expansionary fiscal policy" is expected to drive the economy's growth. She pledged to alleviate living costs and increase public expenditure with the aim of improving the country's strategic industries and quality of life. Among the key campaign proposals was a reduction in the consumption tax on food, without increasing government debt, though no specific details have been provided so far.

Once this is implemented, it should marginally boost growth, at least temporarily. Yet, since the timing and details of tax cuts are uncertain, we have updated our GDP and inflation outlook without factoring in the potential impact of these tax reductions.

Growth is expected to stay above potential in 2026

The ongoing conflict in the Middle East presents considerable uncertainty. Should the situation be resolved within the speculated timeframe, however, growth conditions are expected to remain robust in 2026 due to fiscal support and a recovery in private consumption. Preliminary GDP data for the fourth quarter of 2025 showed just 0.2% annualised growth, but stronger-than-expected capital spending data points to a likely upward revision to 1.2%.

We expect growth momentum to continue in 2026. The effects of the supplementary budget are beginning to take hold, and robust corporate earnings are expected to facilitate sustained wage growth, increased investment, and enhanced government tax revenues. In the face of structural labour shortages, we anticipate that wage growth will exceed 5% for the full-year 2026. As inflation is expected to stay near 2%, real wage growth is expected to turn positive, which should boost private consumption. Meanwhile, the government is likely to increase its spending on defence and strategic industries – such as shipbuilding, semiconductors, and software – which should contribute positively to overall growth. Considering these factors, we expect GDP to rise 1.0% year-on-year in 2026, staying above the potential growth level.

Rising oil prices to raise fiscal strain, likely to push up JGB yields

Based on our updated oil and gas price outlook, we've slightly increased our CPI forecasts for 2026 to 2.1% YoY (vs the previous 2.0%). Despite the heavy dependence on Middle Eastern oil and gas, at this stage, we only expect a brief price increase in the second quarter. We believe that the government is likely to resume energy subsidies during the summer to alleviate cost burdens. The Takaichi administration may face pressure for additional fiscal support, which could lead to upward pressure on Japanese government bond yields. The JGB curve flattened significantly after the lower house election. We view this post-election reaction to be a correction to the overly dramatic pre-election volatility. While the 10Y JGB yield drifted lower to the 2.15% level recently due to rising geopolitical risks, we expect it to rise steadily later.

Meanwhile, we continue to believe a June hike remains a possibility. While temporary oil price hikes are not likely to alter the Bank of Japan's rate hike path, the central bank will need to adopt a more cautious approach. Although two newly nominated members are scheduled to join in March and June (pending parliamentary approval), the two retiring members are also considered dovish, so the BoJ's overall dove-hawk spectrum is unlikely to change significantly.

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